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The Challenge in Quantifying Savings from Supply Management

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The number one mission of the procurement function, in general, is usually to reduce the cost of purchased goods and services, or perhaps to lower total supply chain costs through smart procurement strategies and negotiations.

There's just one problem: measuring the amount of those "savings" is devilishly hard to do.

P. Fraser Johnson and **Michiel R. Leenders**, of the University of West Ontario and the Richard Ivey School of Business, respectively, addressed that topic head on in a recent article for MIT's Sloan Management Review, with some excellent thoughts on both the challenges facing supply managers and how to overcome them.

"Both understatement and overstatement of supply savings gaps signal the wrong reality, leading to an overemphasis on low-yielding cost-saving initiatives, misdirected corporate resources and rewarding employees for the wrong behavior," Johnson and Leenders write. "Perhaps even more frustrating for managers is that supply savings gaps conceal the strategic contribution suppliers can provide."

Major Challenges in Quantifying Savings

System Challenges: Accounting systems are simply not designed at present to well capture supply management "savings" - so, in general, procurement organizations define their own rules about what qualifies and what does not. These definitions can be arbitrary, and drive the wrong behavior. One company the authors studied exerted strong pressure to meet a minimum level of annual "savings," but little upside for going beyond that, leading procurement managers to "bank" savings for later periods and not pursue all savings opportunities.

Who Gets the Credit? Often, supply-based savings are not the result only from the efforts of a single procurement manager, but a team of others both inside and outside procurement. As a result, "Many supply managers look for savings opportunities that do not require the involvement of others, even if this means ignoring high-potential savings areas," the authors say.

One company Johnson and Leenders researched had an elaborate set of rules governing reportable savings. Though the goal was to make sure that savings were "provable beyond any doubt" during the current year and the result of supply effort alone, the approach led to under-reporting off procurement's value and short term versus long term thinking.

Things Change: Overall market pricing, technology, volumes, and number of other variables are all subject to dynamic change. If the supply organization achieves a cost breakthrough relative to competitors say for plastic resins, but then the price of oil spikes and the price of resins soars along with it - is that a "savings" or not?

Even if the company is still paying less than competitors, it may be hard to for execs to accept there has been a savings as the price paid has increased perhaps 30%. Conversely, if technology or market forces drive the price of a component down dramatically, does that count as supply-based savings? All this makes year-over-year comparisons very hard.

Refusal to Account for Cumulative Savings: If the supply organization can set a baseline price with a supplier that gives the company a competitive advantage, those savings often continue over several years, even if the subsequent price rises basically in-line with overall price inflation in the category. The company is still paying below market rates, and the total savings to the company across purchased goods could be huge. But few companies account for or will accept these "multi-year" savings.

Incomplete Definition of Savings: In a sense, this category of challenge is in the supply organization's favor,as companies often focus on say the change in unit price that happens when there is a change in supplier, but rarely capture the other costs associated with the switch (qualification, risk, quality, etc.) that may accompany such a move. On the other hand, companies often do not consider "soft savings" or "cost avoidance" - such as the savvy supply organization that locks in prices right before a big swing upward in the commodity.

Inability to Convert Savings into Profit: Unfortunately, theoretic or even quite achievable savings have a tendency to not actually find their way to the bottom line. Managers may take the savings and use them for other purposes or projects, so that the total cost basis of the business is unchanged.

One CEO was interviewed who had recently received a supply savings report totaling almost $1 billion. However, the corporate income statement for the same period showed a loss of almost $2 billion. "Where did those savings go?" the CEO asked.

Reluctance To Revisit Past Decisions: Johnson and Leenders say that sometimes, supply managers are deterred from looking for savings for fear that in finding them, it will throw a bad light on decisions made by others in the past. "Why was this product designed so badly to begin with," for example, if it turns out one integrated component can replace three separate ones now being used. As such, supply managers can be viewed as "squealers," serving as a barrier to those efforts.

Understating savings frequently shifts the emphasis in procurement organizations from pursuing strategic opportunities to minimizing the administrative costs of running the supply function itself.

Over or Under Reporting of Savings?

As a result of these challenges, Johnson and Leenders conclude that in general, the savings from supply management efforts are more often under rather than over reported.

"Most chief supply officers only report those savings that can be easily substantiated. At almost every organization in our study, cost savings were measured by year-over-year price reductions, frequently referred to as 'hard savings.'" they note.

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Overstating savings, such as by not factoring in the cost of changing suppliers, is equally problematic, giving a false and actually dangerous picture of where things are headed.

"By failing to recognize the true cost implications of major supply initiatives, the company becomes burdened with higher total costs. In the long run, the company rewards behavior for efforts that increase rather than reduce its cost structure," Johnson and Leenders say.

They note that in some companies, supply management "savings" are reported, but not balanced against other areas of increase, again giving a distorted view.

Most can probably agree on the issues and challenges, but what to do about it? We'll summarize Johnson and Leenders' recommendations next week.